The global economy

IB DP Economics Unit 4: trade, protection, integration, exchange rates, balance of payments, development

The global economy

- explain absolute and **comparative advantage** and the gains from trade;
- analyse tariffs, quotas and subsidies with diagrams and numbers, and evaluate protection;
- explain **trading blocs**, **trade creation** and trade diversion;

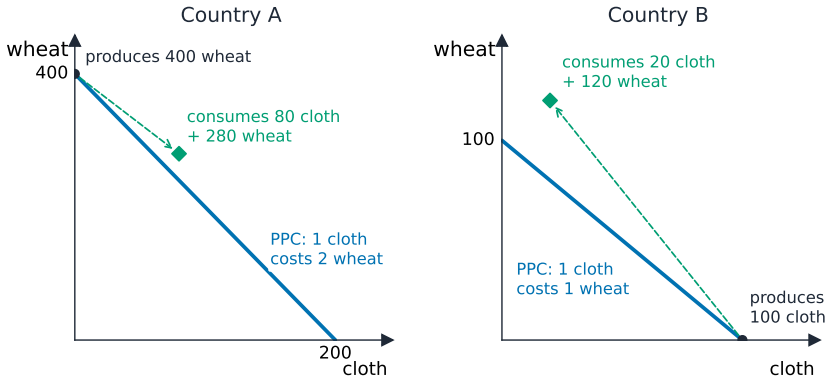
The global economy (2)

- analyse exchange rates and the **balance of payments**, including the HL **Marshall–Lerner condition** and **terms of trade**;
- measure development and evaluate barriers and strategies.

International trade

- International trade gives consumers lower prices and more choice.
- Firms can sell to bigger markets and gain **economies of scale** .
- Competition from abroad pushes local firms to be more efficient.
- Trade also spreads new technology and ideas.

Figure: International trade



- At 1.5 wheat per cloth, both countries consume outside their own PPC.
- Axes: wheat and cloth.

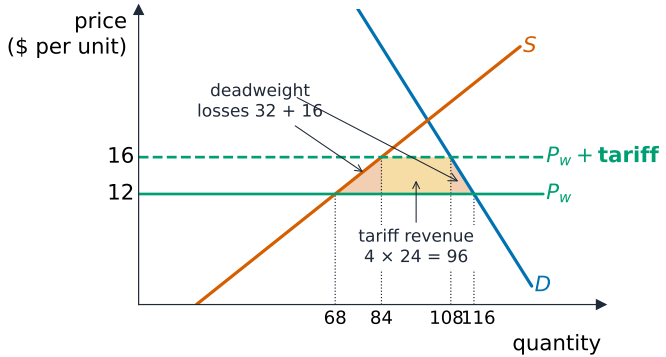
Trade protection

- **Tariffs** : taxes on imports.
- **Quotas** : limits on the quantity of a good that can be imported.
- **Production subsidies** : payments to domestic producers, which lower their costs.

Trade protection (2)

- **Export subsidies** : payments to firms for each unit they export.
- **Administrative barriers** : slow customs checks, strict product standards, or long paperwork that make importing harder.

Figure: Trade protection

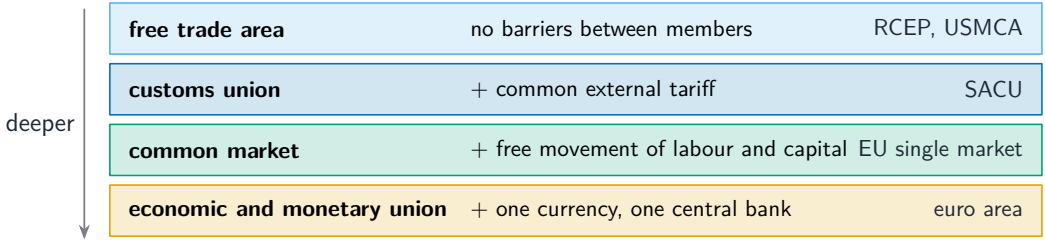


- A **tariff** of 4 halves imports, raises 96 for the government and wastes 48
- Match each part of the diagram to the text.

Economic integration

- A **bilateral** agreement is between two countries. A **multilateral** agreement is among many (such as the WTO's rules).
- A **preferential trade agreement** lowers barriers on some goods only.

Figure: Economic integration



- Each stage adds to the last
- Match each part of the diagram to the text.

Exchange rates

- Demand for yuan comes from foreigners buying Chinese exports, tourists visiting China, and foreign investors buying Chinese assets.
- Supply of yuan comes from Chinese people and firms buying imports, travelling abroad, and investing abroad.
- foreign demand for a country's exports changes;

Exchange rates (2)

- interest rates change (higher rates attract **hot money** , short-term money looking for the best return);
- inflation differs between countries (high inflation makes exports less competitive);
- investors **speculate** that a currency will rise or fall;

Exchange rates (3)

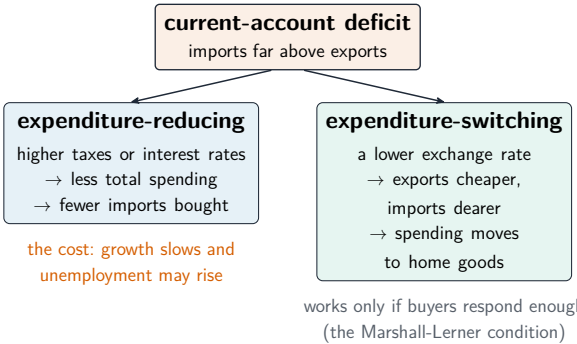
- the central bank buys or sells its own currency.
- Under a **fixed exchange rate** , the government or central bank sets the currency's value against another currency and buys or sells to keep it there. The Hong Kong dollar has been fixed to the US dollar since 1983. A deliberate cut in a fixed rate is a **devaluation** ; a deliberate rise is a **revaluation** .
- A **managed exchange rate** floats, but the central bank steps in to limit big moves. The People's Bank of China sets a daily central rate and lets the yuan move only within a band around it.

The balance of payments

- **Expenditure-switching policies** move spending from imports to domestic goods: protection, or a lower **exchange rate**.
- **Expenditure-reducing policies** cut total spending, and so imports: contractionary fiscal or monetary policy. These can cause unemployment.
- **Supply-side policies** make exports more competitive over the long run.

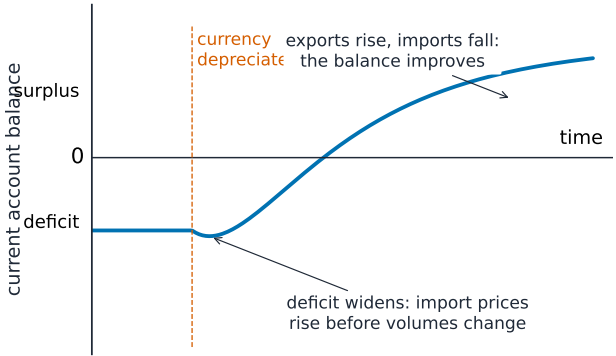
$$\text{terms of trade} = \frac{\text{index of average export prices}}{\text{index of average import prices}} \times 100$$

Figure: The balance of payments



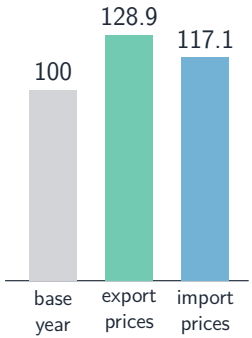
- Two routes out of a deficit: spend less overall, or switch spending to home goods
- Match each part of the diagram to the text.

Figure: The balance of payments ·



- After a **depreciation** the **current account** gets worse before it gets better
- Read the axes and units first.

Figure: The balance of payments · ·



$$\frac{128.9}{117.1} \times 100 \approx 110.1$$

each unit of exports buys about 10% more imports

but dearer exports from domestic inflation may sell less

- **Terms of trade** from two indices
- Match each part of the diagram to the text.

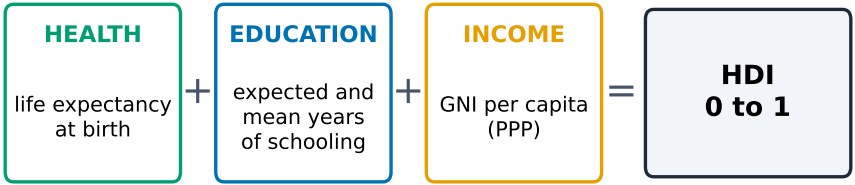
Economic development

- The **poverty trap** : people with low incomes cannot save, so there is little money for investment, so productivity and incomes stay low.
- **Economic barriers**: high inequality; poor infrastructure (roads, power, internet); little access to credit and markets; a large informal economy that pays no taxes; **capital flight** (rich people moving money abroad); and unsustainable foreign debt.
- **Dependence on primary products**: for example, copper makes up most of Zambia's exports, so a fall in the world copper price cuts national income sharply.

Economic development (2)

- **Geography**: being **landlocked** raises transport costs; tropical disease and climate shocks hurt health and farming.
- **Political and social barriers**: weak institutions, corruption, poor legal and property rights, political instability and conflict, and **gender inequality** (when girls cannot go to school, half the country's talent is wasted).

Figure: Economic development



GDP alone misses health and schooling; the GII adds gender inequality

- The **Human Development Index** combines health, education and income
- Match each part of the diagram to the text.

Sources for this lesson

- International Baccalaureate, *Economics guide* (first assessment 2022).
- Suez Canal Authority and Lloyd's List, reports on the *Ever Given* grounding (March 2021).
- **World Trade Organization**, *World Trade Statistical Review*.

Sources for this lesson (2)

- United Nations Development Programme, *Human Development Report*.
- D. Ricardo, *On the Principles of Political Economy and Taxation* (1817), chapter 7.

Common errors

- Confusing absolute and **comparative advantage**; trade depends on **lower opportunity cost**, not on being better at everything.
- Shading the wrong areas on a **tariff** diagram: the deadweight loss is two triangles, one for production and one for consumption.
- Saying a weaker currency always improves the **current account**; at first the J-curve can make it worse, and the Marshall–Lerner condition must hold.

Common errors (2)

- Treating the **balance of payments** as "in deficit overall"; the accounts always sum to zero, but the **current account** alone can be in deficit.
- Using GDP growth as the only sign of development; development also includes health, education, equality and freedom.
- Listing development strategies without explaining their problems.

Key terms

- **Comparative advantage**: the ability to produce a good at a lower **opportunity cost** than another country.
- **Tariff**: a tax on imported goods.
- **Trade diversion**: when a trading bloc causes imports to switch from a cheaper outside producer to a more expensive member.

Key terms (2)

- **Exchange rate**: the price of one currency in terms of another.
- **Current account**: the record of a country's trade in goods and services, **primary income** and **secondary income**.
- **Terms of trade**: the average price of a country's exports relative to the average price of its imports, as an index.
- **Human Development Index**: a composite measure of development based on health, education and income.

Check yourself

- 1.
- In one labour hour Country A can make 4 wheat or 2 cloth; Country B can make 1 wheat or 1 cloth.
- Which country has the **comparative advantage** in cloth? 2.
- On the model, a **tariff** of 4 raises the price from 12 to 16.